Growing Asia's Markets

Asia Securities Industry & Financial Markets Association

Briefing Note
U.S. QFC Stay Rules – Impact on Equity Capital Markets Transactions

DEVELOPING ASIAN CAPITAL MARKETS

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Introduction

The U.S. banking regulators adopted rules (the "QFC Stay Rules") in 2017 to improve the resolvability and resilience of U.S. global systemically important banks ("G-SIBs") and their subsidiaries worldwide, as well as the U.S. subsidiaries, branches and agencies of non-U.S. G-SIBs (together, "Covered Entities"). A list of G-SIBs can be found here. The QFC Stay Rules are intended to mitigate the risk of destabilizing terminations of certain financial contracts, which the regulators perceive as an impediment to the orderly resolution of a G-SIB. They accomplish this by, among other things, requiring that Covered Entities include language in such contracts expressly recognizing the Federal Deposit Insurance Corporation's authority under U.S. special resolution regimes to stay the exercise of default rights under such contracts and to transfer such contracts away from a failing G-SIB. This note sets out a summary of the QFC Stay Rules' effects on documentation for certain types of equity capital markets transactions in Asia.[1] This may include contracts governed by the laws of the United States (e.g. New York law) as well as other laws (e.g. English law). For more background, please see the document prepared by SIFMA here.

The QFC Stay Rules apply to "qualified financial contracts" ("QFCs"), which include "a contract for the purchase, sale or loan of a security". The QFC Stay Rules do not apply to all of a Covered Entity's QFCs. Instead, a QFC is only "in-scope" if it explicitly restricts the transfer of the contract (or a related interest or obligation) away from a Covered Entity or provides for "default rights" that may be exercised against a Covered Entity. Among other things, a "default right" under the QFC Stay Rules includes the right of a non-defaulting party to terminate or accelerate a QFC or transactions under a QFC or modify the obligations of a party thereunder.

This note addresses the requirements of the QFC Stay Rules with respect to "in-scope" QFCs where a *manager* or *underwriter* is a Covered Entity and considers the impact of the rules on typical agreements and specific model agreements available on the ASIFMA website here. It does not focus on the scenario where an issuer or selling shareholder is a Covered Entity. Each Covered Entity should conduct its own analysis of each document it enters into to determine if that document is a QFC and whether it is "in-scope".

[1] The ICMA have published a note regarding the impact of the QFC Stay Rules on documentation for plain vanilla debt securities in primary markets outside the United States - see here.

The QFC Stay Rules require each Covered Entity to conform the terms of any new “in-scope” QFC it enters into, as well as certain pre-existing QFCs, by the applicable compliance date. That date depends on the identity of the other parties to the contract. The relevant dates are:

- January 1, 2019 if each party to the QFC is a Covered Entity;
- July 1, 2019 if each party to the QFC is a financial counterparty or Covered Entity; and
- January 1, 2020 if at least one party to the QFC is neither a financial counterparty nor a Covered Entity.

For the avoidance of doubt, this note does not address a scenario where an agreement contains a cross-default right exercisable against a Covered Entity (i.e., a default right that can be triggered, directly or indirectly, by the insolvency of an affiliate of the Covered Entity) or where the Covered Entity’s obligations under the agreement are guaranteed by an affiliate or subject to another credit enhancement provided by an affiliate of the Covered Entity, as neither of those scenarios are typical in equity capital markets transactions in Europe where the Covered Entity is a manager or underwriter. The language contained in the Appendix may not be sufficient to remediate an “in-scope” QFC that falls within one of these two scenarios.

Summary of QFC Stay Rules’ impact on typical equity capital markets documentation

Below, we refer to certain agreements often used in the context of equity capital markets transactions and provide high-level guidance as to the applicability of the QFC Stay Rules. As noted above, a Covered Entity should scrutinize <u>each</u> agreement to which it is a party to assess whether it is an “in-scope” QFC under the QFC Stay Rules.

- **Underwriting Agreement**

  Headline: *Typically, an underwriting agreement will be considered a QFC because it is a contract for the purchase or sale of a security. It <u>will only be</u> considered an “in-scope” QFC if it contains default rights exercisable or explicit transfer restrictions exercisable against underwriters that are Covered Entities.*

  Each underwriting agreement will need to be reviewed individually to determine if it is an “in-scope” QFC. The following are examples of provision to focus on:

  – Underwriting agreements may contain restrictions barring underwriters that are Covered Entities from transferring any of their rights or obligations under the underwriting agreement (such as typical “no assignment” clauses). This would make the underwriting agreement an “in-scope” QFC and it would need to include the language set out in the Appendix.

  – While default rights against an issuer in an underwriting agreement are common, the most usual ones being an underwriter’s rights to terminate against the issuer if conditions precedent are not met and in certain other circumstances, such rights against underwriters are very uncommon. If it provides any default rights exercisable against an underwriter that is a Covered Entity, however, an underwriting agreement would be an “in-scope” QFC and would need to include the language set out in the Appendix.

- Some underwriting agreements (particularly for initial public offerings) may include a "step-up" provision reallocating shares that have not been purchased by a defaulting underwriter to another underwriter. Such a provision amends the obligations of the underwriters by reducing the defaulting underwriter's right to participate in the offering and increasing the non-defaulting underwriter's participation in the offering. This would constitute a default right against an underwriter that is a Covered Entity and make such underwriting agreements "in-scope" QFCs which would need to include the language set out in the Appendix. This is because the definition of default rights under the QFC Stay Rules includes the right of a party to modify the obligations of another party.

- If a particular underwriting agreement contains transfer restrictions or default rights against a Covered Entity, that agreement will be an in-scope QFC and it will need to include the language set out in the Appendix. In these circumstances, underwriters that are not Covered Entities should bear in mind that, if the syndicate is to include a Covered Entity, that language will need to be included.

• **ASIFMA Standard Form -- Agreement Among Underwriters** (the "Model AAU")

Headline: *The ASIFMA Model AAU will be considered a QFC.*

It will be considered an "in-scope" QFC if it is used without modification or otherwise contains default rights exercisable against or transfer restrictions applicable to underwriters that are Covered Entities.

The Model AAU contemplates that underwriters would purchase unplaced shares and will be a QFC because it is a contract for the purchase or sale of a security. Further, the Model AAU will be considered an "in-scope" QFC because it contains a "step-up" provision that reallocates shares that have not been purchased by a defaulting underwriter to another underwriter, which amends the obligations of the underwriters by reducing the defaulting underwriter's right to participate in the offering and increasing the non-defaulting underwriter's participation in the offering. The ASIFMA Model AAU includes QFC language.

• **ASIFMA Standardized Secondary Block Trade Agreements (with or without Backstop)** (the "Standardized Block Trade Agreements")

Headline: *The ASIFMA Standardized Block Trade Agreements (if used without modification) will not be an "in-scope" QFC for Covered Entity managers.*

If the Standardized Block Trade Agreement contemplates a backstop arrangement, the manager is required to purchase any shares that are unsold and therefore is a contract for the purchase of securities which makes this contract a QFC.

However, for either a backstopped or non-backstopped arrangement, the Standardized Block Trade Agreements do not contain transfer restrictions on a manager. While the managers may terminate the agreement if conditions precedent are not satisfied, there are no termination rights exercisable against a manager. As such, even if the modified Model No-Backstop Block Trade Agreement is a QFC, it will not be an "in-scope" QFC. Nevertheless, in the event the agreement is modified for a particular offering such that it becomes a in-scope QFC, ASIFMA has included QFC language in brackets for the sake of convenience.

- **Stock Loan Agreement/Stock Lending Agreement**

  Headline: *Typically, a stock loan agreement will be considered a QFC. It will be considered an "in-scope" QFC if it contains default rights exercisable against or transfer restrictions applicable to Covered Entities.*

  A stock loan agreement contemplates that a Covered Entity borrower borrows shares and will therefore be a QFC because it is a contract for the loan of a security.

  Many stock loan agreements contain either default rights exercisable against, and transfer restrictions applicable to, borrowers/stabilizing managers, or both. If a stock loan agreement does contain such a default right or a transfer restriction, it will be considered an "in-scope" QFC and the language contained in the Appendix will need to be included.

- **Sub-Underwriting Letters**

  Headline: *Typically, a sub-underwriting letter will be considered a QFC.*

  It will be considered an "in-scope" QFC if it contains default rights exercisable against or transfer restrictions applicable to Covered Entities.

  A typical sub-underwriting letter is entered into between an underwriter to an offering (invariably by way of a rights issue or rights offering) and a sub-underwriter. Such a letter typically contemplates that sub-underwriters subscribe for shares under certain circumstances and will therefore be a QFC because it is a contract for the purchase or sale of a security.

  To the extent that a sub-underwriting letter contains default rights exercisable against, or transfer restrictions applicable to, a Covered Entity underwriter or sub-underwriter, it would be considered an "in-scope" QFC and the sub-underwriting letter would need to include the language contained in the Appendix.

  A sub-underwriting letter will typically make performance under the sub-underwriting letter conditional on the completion of the related underwriting agreement. In such circumstances, to the extent that the exercise of a termination right in the related underwriting agreement effectively terminates the sub-underwriting letter as well, that right (whether held by the primary underwriters or the issuer) would likely be considered a default right against sub-underwriters, and accordingly, the sub-underwriting letter would be considered an "in-scope" QFC and the language contained in the Appendix would need to be included in such a sub-underwriting letter.

- **Standby Underwriting Commitment Letters**

  Headline: *Typically, a typical standby underwriting letter will be considered a QFC.*

  It will be considered an "in-scope" QFC if it contains default rights exercisable against, or transfer restrictions applicable to Covered Entities.

A standby underwriting letter establishes parameters for a bank to underwrite a potential future offering of securities. Such a letter thus contemplates the underwriter's purchase of securities from the issuer and is therefore a "securities contract" and a QFC.

Similar to an underwriting agreement, default rights exercisable against underwriters are uncommon, although certain standby underwriting letters may include a "step-up" provision reallocating shares that have not been purchased by a defaulting underwriter to another underwriter. Such a provision will make such standby underwriting letters "in-scope" QFCs and would need to include the language contained in the Appendix.

Furthermore. to the extent that a standby underwriting letter contains any other default rights exercisable against, or a transfer restriction applicable to, an underwriter that is a Covered Entity (including any such right or restriction that is incorporated by reference), it would be an "in-scope" QFC and the language contained in the Appendix would need to be included in such a standby underwriting letter.

Appendix

Language for inclusion in the relevant agreement

[ ]. Recognition of the U.S. Special Resolution Regimes

(1) In the event that any Manager[2] that is a Covered Entity becomes subject to a proceeding under a U.S. Special Resolution Regime, the transfer from such Manager of this Agreement, and any interest and obligation in or under this Agreement, will be effective to the same extent as the transfer would be effective under the U.S. Special Resolution Regime if this Agreement, and any such interest and obligation, were governed by the laws of the United States or a state of the United States.

(2) In the event that any Manager that is a Covered Entity or a Covered Affiliate of such Manager becomes subject to a proceeding under a U.S. Special Resolution Regime, Default Rights under this Agreement that may be exercised against such Manager are permitted to be exercised to no greater extent than such Default Rights could be exercised under the U.S. Special Resolution Regime if this Agreement were governed by the laws of the United States or a state of the United States.

"Covered Affiliate" has the meaning assigned to the term "affiliate" in, and shall be interpreted in accordance with, 12 U.S.C. § 1841(k).

"Covered Entity" means any of the following:

(i) a "covered entity" as that term is defined in, and interpreted in accordance with, 12 C.F.R. § 252.82(b);

(ii) a "covered bank" as that term is defined in, and interpreted in accordance with, 12 C.F.R. § 47.3(b); or

(iii) a "covered FSI" as that term is defined in, and interpreted in accordance with, 12 C.F.R. § 382.2(b).

"Default Right" has the meaning assigned to that term in, and shall be interpreted in accordance with, 12 C.F.R. §§ 252.81, 47.2 or 382.1, as applicable.

"U.S. Special Resolution Regime" means each of (i) the U.S. Federal Deposit Insurance Act and the regulations promulgated thereunder and (ii) Title II of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act and the regulations promulgated thereunder.

[2] Replace with "Dealer" or other term throughout to conform terminology to the relevant agreement.